A Closer Look at 2023

Daniel Paserman takes a look at certain tax developments that transpired in Israel throughout 2023.

This article examines certain noteworthy developments that have shaped the Israeli tax sphere over the past year, with a particular focus on legal ramifications of notable court rulings, the implications of a new proposed international tax reform, and updates within the high-tech sector.

MEDTRONIC CASE: NEW JUDGMENT REGARDING "BUSINESS RESTRUCTURING"

In June 2023, the judgment in the matter of Medtronic Venture Technologies was published. The judgment addressed a claim of a "Business Restructuring", specifically, the sale of FAR (functions, assets, and risks), a claim commonly asserted by the Israel Tax Authority ("ITA") in cases involving the acquisition of Israeli companies by international groups. This ruling joins previous District Court judgments in the cases of Gteko (2017), Broadcom (2019), and Medingo (2022) (our firm represented the taxpayers in the Broadcom and Medingo cases).

Medtronic Inc., which heads an international group specializing in the development, manufacturing, and marketing of medical products, purchased all of the shares of an Israeli start-up. In keeping with standard practice, the Israeli target entered into a number of agreements with companies in the Medtronic Group following the acquisition, including R&D and license agreements. The Tax Assessor contended that, as a result of these inter-company agreements, the Israeli company had effectively transferred its FAR to entities within the Medtronic Group outside of Israel. Consequently, the interaction between the parties should be viewed as a transaction for the sale of FAR and should be taxed accordingly.

The Honorable Judge Borenstein, in his ruling, cited prominent case law on the issue of "Business Restructuring" and outlined a spectrum of cases. On one end, there are clear-cut cases of transferring functions and assets within a short period of time while leaving a corporate shell, as in the Gteko case. On the other end of the spectrum, there are cases involving active companies that continue to grow, maintain, and develop their intellectual property, as in the Broadcom case.

In this case, the judge determined that the circumstances paralleled those of the Gteko case, leading to the ruling that the FAR of the Israeli company had been sold.

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The court's judgment emphasizes the importance of the international group's conduct following the acquisition of an Israeli company, particularly in the development and implementation of intercompany relationships and the set of contracts among the group's companies. For instance, the intellectual property that was owned by the company permeated to Medtronic Group over time, and it was not sold by the company, not even upon the closure of its activities. Moreover, the ruling highlights the importance of strategic planning for the transaction and its meticulous

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implementation, as well as the impact of the tax assessment procedures on the subsequent litigation process in court.

Following four District Court judgments regarding "Business Restructuring," the legal framework is becoming clearer, establishing guiding principles for the examination of such cases by the courts. The judges emphasize the importance of detailed factual analysis of each case, particularly focusing on factors such as the group's involvement, the company's independence, mechanisms for the registration and protection of its intellectual property; and other relevant considerations.

BEIT HOSEN CASE - NEW JUDGMENT REGARDING SHARE REPURCHASE

In February 2023, for the first time, the Supreme Court addressed the tax implications of a disproportionate share repurchase. The judgment involved two cases in which a company executed a share-repurchase, acquiring its own shares from some of its shareholders (selling shareholders), in a manner that was not proportionate with their ownership. This led to an increase in the percentage of ownership held by the remaining shareholders in the company.

The panel of judges was divided on the matter. The minority opinion held that the "dominant purpose" of the share-repurchase must be examined, determining whether the transaction resulted from a conflict among shareholders and whether its primary objective was to benefit the company rather than the individual shareholders. Based on this approach, if the share-repurchase is intended to benefit the company, it should not be taxed as a dividend. However, if the share-repurchase is intended to benefit the shareholders, it should be treated as a taxable dividend for all shareholders at the time of the transaction - unless there was a conflict among shareholders, in which case the entire dividend should be allocated to the remaining shareholder (and the seller would be liable for capital gain tax).

In contrast, the majority opinion asserted that when dealing with a share-repurchase within a private company operating as a quasi-partnership, it is inappropriate to attempt to pinpoint the dominant purpose behind the share-repurchase, as this determination is challenging to make and apply. A quasi-partnership company is a private entity with a limited number of shareholders who share personal relationships based on mutual trust, often engaging in joint management. In such entities, it is difficult to identify the dominant purpose, and it is questionable whether one exists. It can be presumed that the separation of shareholders benefits both individuals and the company, and their considerations are intertwined. Adopting the "dominant purpose" test may open the door to manipulation by shareholders in order to reduce taxes. Tax law should adopt a clear and straightforward test to ensure clarity and stability.

In light of the above, it was concluded that the "dominant purpose" test should not be adopted. Rather, the remaining shareholders should be obligated to include a portion of the share-repurchase sum in their taxable income, proportionate to their

respective ownership shares as of the purchase date. In other words, the transaction should be viewed as a two-stage process: In the first stage, a dividend is distributed to each shareholder based on their proportionate share of the total share-repurchase amount; and in the second stage, the remaining shareholders acquire from the selling shareholders their shares for the amount of the dividend they received.

The majority judges emphasized that their ruling only applies to private companies functioning as quasi-partnerships, and it is not establishing rules for other types of companies, including private companies not operating as quasi-partnerships as well as public companies.

GOTTEX CASE - NEW JUDGMENT REGARDING NON-COMPETE UNDERTAKING

In March 2023, the District Court issued a judgment on the Gottex case, which was represented by our office. The ruling addressed several complex tax issues, including the question of whether payment for a non-compete undertaking, in the context of share acquisition, could be recognized as a separate deductible expense.

The case involved two companies, each holding a 50% stake in Gottex Swimwear Brands. One shareholder acquired the shares of the other, and, in addition to the payment for the shares, the acquired company made a separate payment to the selling shareholder in consideration of its commitment not to compete with the company. The acquired company sought to classify this payment as a deductible expense. The ITA contended that the various elements of consideration should not be treated separately but should instead be viewed as a consolidated sum, representing the acquiring shareholder's comprehensive payment for the purchase of shares from the selling shareholder, and thus this payment cannot be deducted by the target company as a deductible expense

The court determined that it is possible to distinguish between the compensation paid for the shares and the compensation paid for the non-compete clause. Provided that the non-compete clause is authentic, and is not intended solely for tax reduction, and there is a legitimate risk of the selling shareholder competing with the acquired company, a separate payment can be designated for the seller's commitment not to compete in the acquired company's business. Just as it is possible to treat the compensation received for a non-compete clause separately from the sale of shares, treating it as taxable income, conversely, it is viable to separate the payment for non-competition from the payment for shares and recognize it as a deductible expense.

Another issue considered by the court was whether the expense associated with the non-compete clause should be assigned to the acquired company or to the acquiring shareholder. On the one hand, the non-compete clause is part of the stock acquisition transaction, intended to protect the interests of the shareholders and secure their investment. On the other hand, the activity subject to the non-compete clause occur within the acquired company, which is the entity wherein potential competition might transpire. The court ruled that it is necessary to assess who holds the primary interest in the non-compete clause based on the circumstances of each case.

In this instance, the court acknowledged the authenticity and value of the non-compete clause, affirming that, in principle, it could be deemed a deductible expense. However, the court concluded that, given the circumstances of this case, the expense should be attributed to the acquiring shareholder rather than the company that was sold.

NEW PROPOSED INTERNATIONAL TAX REFORM

In November 2021, The Committee for International Tax Reform published recommendations for revisions in the Israeli international tax regime. In 2023, the government took the first steps for the implementation of some of the Committee's recommendations, with the Israeli Ministry of Finance publishing proposed bills addressing individual's tax residency, controlled foreign corporations (CFC), and foreign tax credits.

Individual's Tax Residency: Under the current rules, Israeli residency for tax purposes is based on the "center of life" test, which examines various factors such as familial, economic, and social ties. In addition, the number of days spent in Israel is impor-

tant as the ITO provides two alternative residency presumptions that are rebuttable. An individual staying in Israel for more than 183 days in a tax year or more than 425 days over three consecutive tax years (with at least 30 days in the third tax year) is presumed to be an Israeli tax resident. The proposed legislation maintains the "center of life" test and the existing rebuttable presumptions, but also introduces stricter, irrefutable presumptions for determining tax residency. According to the proposed changes, an individual would be considered a tax resident of Israel if any of the following conditions are met, including inter alia: staying in Israel for more than 183 days for two consecutive tax years; exceeding 100 days in a tax year and 450 days over three consecutive tax years; or spending over 100 days in a tax year while their spouse is an Israeli resident.

At the same time, the proposed legislation introduces irrefutable presumptions to determine that an individual is a foreign tax resident, including: spending less than 30 days per tax year in Israel, during each of the recent 3-4 tax years; an individual and her/his spouse spend less than 60 days per tax year in Israel for each of the recent 3-4 tax years; an individual and her/his spouse spend less than 100 days per tax year in Israel for each of the recent 3-4 tax years, while spending over 183 days in a treaty country, and obtain a certificate of residency therefrom.

Controlled Foreign Company ("CFC"): CFC rules, as they apply in Israel today, stipulate that, under certain conditions, passive profits of a foreign corporation controlled by Israeli residents are considered a "deemed dividend" distributed to the Israeli shareholders. The proposed bill expands the definition of passive income to include certain business income, under certain circumstances, that is received from related parties. Additionally, it lowers the passive income threshold for classifying a company as a CFC to 1/3 of the total income or profits of the foreign company (instead of half). The proposed legislation also imposes stricter conditions on foreign companies that are residents of a country that is in the "black" or "gray" lists of the EU (excluding treaty countries) or residents of a country with which Israel does not have an agreement that allows for the exchange of information.

The purpose of this special legislation is to encourage the development of Israeli high-tech companies, particularly those in their initial stages.

Furthermore, as part of the proposed legislation, the holdings of new Israeli residents and veteran returning residents will be considered holdings of Israeli residents and will be taken into account while determining whether a foreign corporation is a CFC. This provision will apply only to assets purchased after their move/return to Israel.

Foreign Tax Credit: Currently, Israel uses the "Basket Method," for tax credit, where each income source on which tax was paid outside of Israel is treated as a separate "basket." The foreign tax is then credited only against the Israeli tax paid for that specific "basket". The proposed bill seeks to reduce the number of "baskets" used in the "Basket Method," denies credit for foreign tax paid in certain cases or in certain countries, and prevents the use of excess credit in subsequent years, except in specific cases.

NEW TAX BENEFITS FOR THE ISRAELI HIGH-TECH INDUSTRY

In July 2023, the Israeli Parliament (the Knesset) approved the Law for Encouragement of Knowledge-Intensive Industry (temporary order). The purpose of this special legislation is to encourage the development of Israeli high-tech companies, particularly those in their initial stages (start-up companies), whose intellectual property is registered in Israel and have their primary operations in the country. The law is designed to promote investment in these companies.

The new legislation grants five tax benefits:

1. Tax credit for individuals who invest in Israeli start-up companies, calculated as the investment amount multiplied by the investor's capital gains tax rate.
2. Deferral of capital gains tax on the sale of shares

of an Israeli technology company when the selling shareholder reinvests the proceeds from the sale in another Israeli start-up company.

3. Authorization for large Israeli technological companies acquiring other technological companies (Israeli or foreign) to deduct the amount of investment for tax purposes over a 5-year period.

4. Tax exemption to foreign financial institutions on interest income from loans extended to Israeli technology companies.

5. Extension of the validity (with certain conditions amended) of tax benefits related to investment in shares of public technology companies. This extension allows investors to recognize a capital loss equal to their investment amount, up to ILS 5 million.

These tax benefits have the potential to result in significant tax savings for certain investors, high-tech companies, and financial institutions. The new tax benefits will be in effect until the end of 2026, and their extension will be examined at that time.

ISRAEL TAX AUTHORITY PUBLISHES GUIDELINES REGARDING SAFE INVESTMENTS

In May 2023, ITA clarified its position on the tax issues applicable to investments made through a Simple Agreement for Future Equity (SAFE). The ITA addressed the issue after a time of uncertainty, providing much-needed clarity for companies seeking to attract investors and secure sources of financing.

In a SAFE transaction, the investor's capital injection doesn't immediately result in the allocation of shares; instead, shares are assigned at a later stage, generally during a broader and more substantial round of fundraising when the company's value is determined. At this point, the SAFE investor receives a discount relative to this value. The main issue addressed by the ITA in this context was the classification of the discount component in the SAFE investment. Specifically, the ITA examined whether the difference between the investment amount at the time of the SAFE transaction and the fair value of the shares allocated to the investor based on the value on the subsequent date of exercise would be classified as interest income.

The ITA issued a "Safe Harbor" letter, outlining that, under certain conditions, a SAFE investment will be considered an advance payment on account of shares. Consequently, no tax event will occur on the date of the exercise into shares, and the company will not be subject to any obligation to withhold tax in this regard. The ITA's guidance clarifies that if, on the exercise date, the outlined conditions are not met, it will not determine the classification of the SAFE investment for tax purposes, and this classification will be determined based on the overall circumstances of the transaction.

The ITA's guidance applies to Israeli-resident private companies operating in the high-tech industry which are at the stage where most of their expenses are classified as research and development, production, or marketing expenses related to their developed products. Additionally, the guidance is relevant to companies that have not conducted a fundraising round on a known share value during the three-month period prior to the SAFE Agreement's closing date. The ITA's guidance applies solely to SAFE investments which comply with a long and challenging list of specific conditions and which have been signed or will be signed between companies and SAFE investors by December 31, 2024, or in accordance with other guidance that will be issued by the ITA. ■

ABOUT THE AUTHOR

Adv. Paserman is the head of Gornitzky GNY's tax practice. Daniel is involved in intricate corporate tax planning - both domestic and cross-border. His experience includes negotiations vis-à-vis the Israel Tax Authority regarding tax regulatory issues, seeking and obtaining tax rulings for both Israeli and global companies operating in Israel, as well as handling complex, wide-scope tax assessments for both international and Israeli corporations.

Daniel also serves as the Co-Chair of STEP Israel. He advises private clients in matters concerning family wealth planning and preservation, specializing in taxation of trusts and estates and provides tax planning guidance for high-net-worth individuals.

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